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No. 91-1361

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

DELTA HOLDINGS, INC.,

Petitioner,

—against—

NATIONAL DISTILLERS AND CHEMICAL CORPORATION,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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Preliminary Statement

Petitioner submits this brief in reply to respondent's Brief in Opposition to Writ of Certiorari ("Opp. Br."). Respondent's brief fails to confront the issues of broad public importance presented in the Petition for Writ of Certiorari (the "Petition"):

1. Respondent does not even attempt to rebut Delta's showing that effective enforcement of the nation's securities laws would be seriously impeded by the holding of the Second Circuit—contrary to the decisions of this Court and

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1 Petitioner has no parent corporation, subsidiaries or affiliates.

other circuits—that misstatements of reserve liabilities in financial statements are effectively immune from scrutiny under the federal securities laws. Rather, respondent argues that the decision below was based on state contract law. It is axiomatic, however, that federal, not state, law determines what is an actionable misrepresentation under the federal securities laws. And as we have demonstrated, the decision below conflicts with the *federal* securities laws as interpreted by this Court and other circuits, and would seriously undermine the fundamental policies underpinning those laws.

2. Respondent does not attempt to justify the court of appeals' far-reaching change in the federal securities laws: its holding—contrary to decisions of this Court and other circuits—that a subjective materiality standard applies to investors who have retained professional advisors. Instead, respondent states that the materiality of an omission depends on the total mix of information available—which is beside the point. Respondent does not address the consequences of the holding below, which would impair the ability of investors to obtain redress under the federal securities laws.

3. Respondent argues that this Court should defer to the factual conclusions of the court of appeals as a reasonable interpretation of the evidence. But under Fed. R. Civ. P. 52(a), the issue is not whether the court of appeals' conclusions reflected a permissible view of the evidence, but whether the *district* court's findings had evidentiary support. Indeed, respondent's argument confirms what the Petition demonstrated—that the court of appeals impermissibly substituted its own findings for amply supported findings of the district court.

ARGUMENT

I. RESPONDENT'S MISPLACED RELIANCE ON STATE LAW CANNOT AVOID THE SIGNIFICANT FEDERAL SECURITIES LAW ISSUE RAISED BY THE PETITION.

The court of appeals held that respondent's false representations could not give rise to liability under the federal securities laws because they involved reserves, *i.e.*, an estimation of future payments. App. at 44a. The court explained that a loss reserve liability is not subject to precise quantification "like a debt with fixed payments of principal and interest;" to estimate a reserve liability, "informed guesswork" is required. App. at 51a. Accordingly, the Second Circuit held that a reserve liability reflecting an estimate of future payments, even when falsely stated, is too soft a number on which to base liability under the federal statutes. *This* holding—contrary to the decisions of this Court and of other circuits—gives rise to the question of general applicability and profound public importance presented by the Petition. (*See* Petition at 10-16).

Rather than coming to grips with the substance of the Petition, respondent's principal contention is that the "Court of Appeals . . . resolved the primary issue presented for review under state contract law, not the federal securities laws." (Opp. Br. at 12). According to respondent, the Second Circuit held that respondent's false statements were not misrepresentations under state law; therefore, respondent asserts, the Second Circuit's decision is not properly reviewable by this Court.[2]

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2 Respondent's argument that "the Court of Appeals did not reach the reserve claim under the federal securities laws" (Opp. Br. at 14 n.14) is frivolous. The court of appeals reversed the district court as to *all* of Delta's claims, including those under the securities laws. Therefore, the court of appeals' discussion of respondent's misrepresentation of Elkhorn's net worth must apply not only to Delta's breach of warranty claim, but to its claims under the federal securities laws as well. (*See* Petition at 7 n.5).

Respondent's argument is unsound. *Federal*, not state, law controls what is and is not an actionable misrepresentation under the federal securities laws. *See Basic Inc. v. Levinson*, 485 U.S. 224, 244, n.22 (1988) ("Actions under Rule 10b-5 are distinct from common-law deceit and misrepresentation claims . . . and are in part designed to add to the protections provided investors by the common law"); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 388-89 (1983) ("the antifraud provisions of the securities laws are not coextensive with common-law doctrines of fraud. Indeed, an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct . . . ") (footnote omitted).[3]

Respondent has no answer to Delta's showing that under *federal* law, the Second Circuit's holding is contrary to settled doctrine and, if not reviewed by this Court, will impede effective enforcement of the securities laws with respect to information of great importance to investors—corporate financial statements. Respondent does not contest the facts that the integrity of financial reporting by banks, insurance companies and other financial institutions depends on the accurate statement of reserve liabilities and that the court of appeals' decision would all but remove such critically important information from the purview of the federal securities laws. Instead, respondent relies on its spurious "state law" argument.

Contrary to respondent's argument, the decision below did not turn on the particular facts; its fulcrum was the Second Circuit's unprecedented and dangerous ruling that loss reserves in financial statements are necessarily the product of estimation or "guesswork" and therefore cannot be the basis of claims under § 12(2) or § 10(b). If the proper legal standards had been applied to the facts accepted by the Second Circuit, the district court's judgment could only have been

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3 *See also Brannan v. Eisenstein*, 804 F.2d 1041, 1046 (8th Cir. 1986) (federal courts applying the federal securities statutes are not bound by characterization of defendants as sellers under state law).

affirmed: As the court of appeals acknowledged, "Elkhorn was insolvent as of June 30, 1983" (App. at 44a), *i.e.*, Elkhorn's balance sheet showing a net worth of $18 million was *not* "complete and accurate in all material respects" and did *not* "present[ ] fairly the financial position of Elkhorn as at that date" as respondent had represented.[4] And, as the court of appeals acknowledged, the falsity of respondent's representation "could have been detected from information available as of that date." App. at 44a.[5] These facts alone—which the court of appeals *accepted*—should have mandated affirmance, because the finding that respondent reasonably could have known of the falsity of its representation stripped away respondent's only possible defense under § 12(2): that "in the exercise of reasonable care [it] could not have known, of [the] untruth or omission."[6] Yet rather than applying the statutory standard, the court of appeals reversed the district court on the ground that an understated reserve liability is merely a wrong guess about future events and hence not subject to scrutiny under the federal securities laws. In the absence of review by this Court, that holding would blunt the effective enforcement of the securities laws for the protection of the investing public.[7]

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4 In an example of doublespeak, respondent repeatedly asserts that its representations were "truthful." (Opp. Br. at 4, 13, 14, 18). If it is "truthful" to represent that a balance sheet showing a net worth of $18 million "fairly presents the financial position" of an insolvent company, it is hard to imagine what respondent would call false.

5 The court of appeals' acknowledgement that Elkhorn's understatement of reserves and insolvency "could have been detected from information *available as of that date*" (App. at 44a; emphasis added) puts to rest respondent's argument that Elkhorn's insolvency and gross understatement of reserves could be known only in light of hindsight. (Opp. Br. at 5, 13-14 & n.13).

6 Similarly, as set forth in the Petition, the district court's findings of fact which the Second Circuit did not find to be clearly erroneous establish that respondent met the "recklessness" scienter standard under § 10(b) adopted by virtually all other courts of appeals. (Petition at 8-9, 16-18, 22-23).

7 Respondent attempts to recast the issue as simply involving the reasonableness of Elkhorn's reserving procedures under GAAP. (Opp.

Respondent also suggests (Opp. Br. at 4, 5, 7-11, 14 & n.13, 17 n.18) that Delta was in as good a position as respondent to discover Elkhorn's true financial position. That, however, is legally irrelevant. Under the plain language of § 12(2) ("the purchaser not knowing of such untruth or omission"), a seller who misrepresents or omits a material fact is liable unless the purchaser has *actual* knowledge of the untruth or omission.[8] And neither of the courts below suggested that when Delta purchased Elkhorn's stock, it knew of Elkhorn's insolvency or gross understatement of reserves. Similarly, under § 10(b), liability attaches unless the plaintiff was reckless[9]—and neither of the courts below found Delta to have been reckless.

Br. at 4, 6, 13-14 & n.13, 18 & n.20). The issue, however, is not merely reasonableness under GAAP, but whether the Second Circuit correctly applied federal securities law when it held as a matter of law that there was no actionable misrepresentation or failure to disclose a material fact.

Similarly, respondent's argument (Opp. Br. at 5, 19) that the method of establishing reserves described in the Tillinghast reports was in the public domain is beside the point. The district court's judgment was not based on respondent's failure to disclose methods of calculating reserves, but on its failure to disclose the information in those reports which revealed Elkhorn's enormous understatement of its reserve liability.

8 *See Wright v. National Warranty Co., L.P.*, 953 F.2d 256, 262 (6th Cir. 1992) ("the statute bars recovery only when a plaintiff has actual knowledge that a representation is false or knows that existing information has been withheld"); *MidAmerica Federal Savings and Loan Ass'n v. Shearson/American Express, Inc.*, 886 F.2d 1249, 1256-57 (10th Cir. 1989) ("A purchaser has no duty to investigate a seller's possible fraud and need not verify a statement's accuracy. . . . [T]he plain meaning of . . . section 12(2) . . . requires only that purchasers of securities show a lack of actual knowledge . . . in order to prevail"); *Casella v. Webb*, 883 F.2d 805, 809 (9th Cir. 1989) ("Constructive knowledge cannot bar a purchaser's recovery under section 12(2). . . . [P]urchasers may recover unless they have actual knowledge of the untruth or omission").

9 *Wright*, 953 F.2d at 261 ("A recklessness standard is to be used in determining whether the plaintiff justifiably relied on a misrepresentation or omission"); *Molecular Technology Corp. v. Valentine*, 925

As explained above, the facts that *were* found by the district court (and not found clearly erroneous on appeal) would have resulted in affirmance, were it not for the court of appeals' mistaken rule of law—a rule which would do untold mischief to the effective enforcement of the securities laws and accordingly merits review by this Court.

II. RESPONDENT FAILS TO JUSTIFY THE COURT OF APPEALS' FAR-REACHING CHANGE IN THE MATERIALITY STANDARD UNDER THE SECURITIES LAWS.

In overturning the district court's finding as to the materiality of the actuarial reports concealed from Delta by respondent, the Second Circuit held that a subjective materiality standard applies when the investor has employed professional advisors, rather than the objective standard of what would be significant to a reasonable investor. (Petition at 18-20).[10] Respondent counters with the irrelevant observation that materiality is determined on a case by case basis depending on the total mix of information available. (Opp. Br. at 15-16). While materiality may depend on the total mix of information available, the question of materiality remains "an objective one, involving the significance of an omitted or misrepresented fact *to a reasonable investor.*" *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 445 (1976) (emphasis added). There is "no authority . . . for varying

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F.2d 910, 918 (6th Cir. 1991); *Royal American Managers, Inc. v. IRC Holding Corp.*, 885 F.2d 1011, 1016 (2d Cir. 1989) ("a plaintiff bears only the burden of negating its own 'recklessness,' once the issue of diligence is raised by defendant"); *Dupuy v. Dupuy*, 551 F.2d 1005, 1020 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977).

10 Respondent states that Tillinghast "did not express an opinion on the adequacy of the reserves." (Opp. Br. at 7.) What respondent neglects to mention is that respondent instructed Tillinghast not to calculate the reserves. App. at 61a. The district court found that respondent's reason for so instructing Tillinghast was that respondent knew such a calculation "would record that Elkhorn's loss reserves were seriously understated." *Id.*

the standard of materiality depending on who brings the action . . . ." *Basic Inc. v. Levinson*, 485 U.S. 224, 240 n.18 (1988).[11]

As set forth in the Petition, the court of appeals' holding that materiality turns on the subjective interests of the investor's particular advisors is at odds with the decisions of this Court and other courts of appeals and would seriously undermine the applicability of the federal securities laws to securities transactions in which the investor has retained advisors.[12]

III. RESPONDENT FAILS TO REBUT DELTA'S SHOWING THAT THE SECOND CIRCUIT VIOLATED THE MANDATE OF FED. R. CIV. P. 52

As set forth in the Petition, the Second Circuit violated Fed. R. Civ. P. 52(a)'s mandate that findings of the district court not be set aside unless "clearly erroneous." (Petition at 21-25). Respondent's brief, far from rebutting Delta's showing, actually supports its position.

Respondent *concedes* that reasonable judges may differ as to the inferences to be drawn from the record evidence in this case: "[A]nother reviewing panel might 'find the record

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11 All but one of the cases cited by respondent held that materiality is determined by the *objective* standard of what would be significant to a reasonable investor, not by the subjective standard of what would be of interest to the particular investor. *Basic Inc. v. Levinson*, 485 U.S. at 231-32; *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. at 445, 449; *Kademian v. Ladish Co.*, 792 F.2d 614, 623 (7th Cir. 1986); *Michaels v. Michaels*, 767 F.2d 1185, 1196 & n.3 (7th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986). *Titan Group, Inc. v. Faggen*, 513 F.2d 234 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975), cited by respondent, is inconsistent with this Court's subsequent decision in *TSC Industries*.

12 As set forth in the Petition (pp. 20-21), the Second Circuit's materiality standard was legally deficient in another respect as well: The court of appeals concluded that the Tillinghast reports were not material because they "would not have changed events," App. at 38a, in conflict with the decisions of this Court that information need not be outcome-determinative to be material. Finding no way to justify the Second Circuit's departure from this Court's decisions, respondent simply ignores the issue.

tilting one way rather than the other, though fair-minded judges could find it tilting either way' . . . ." (Opp. Br. at 18, quoting *NLRB v. Pittsburgh Steamship Co.*, 340 U.S. 498, 503 (1951)). If respondent is correct that reasonable judges may differ, then by definition the Second Circuit usurped the trial court's function by substituting its own findings for those of the district court. As this Court has declared, Rule 52(a)

> plainly does not entitle a reviewing court to reverse the finding of the trier of fact simply because it is convinced that it would have decided the case differently. The reviewing court oversteps the bounds of its duty under Rule 52(a) if it undertakes to duplicate the role of the lower court. . . . If the district court's account of the evidence is plausible in light of the record viewed in its entirety, the court of appeals may not reverse it even though convinced that had it been sitting as the trier of fact, it would have weighed the evidence differently. *Where there are two permissible views of the evidence, the factfinder's choice between them cannot be clearly erroneous.*

Anderson v. Bessemer City, 470 U.S. 564, 573-74 (1985) (emphasis added).

Respondent does not even attempt to show that the district court's findings were not a "permissible view[ ] of the evidence." Instead, it attempts to reargue the facts. But the proper place for that was in the district court. This Court should grant review pursuant to its supervisory power over the federal judicial system to correct the court of appeals' extreme departure from the bedrock principle of federal appellate review—Rule 52(a)'s mandate of deference to the factual findings of the trial court.

CONCLUSION

For the reasons stated above and in the Petition, the Court should grant a writ of certiorari in this case.

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